FRBSF Weekly Letter

August 29, 1986

In Dubious Battle

New economic developments made a turbulent decade of the 1970s, presenting problems and sometimes conflicting objectives to both fiscal and monetary policy and leading Congress to mandate significant changes in the Fed's responsibilities, goals and structure.

"New Economic Policy"

When President Nixon announced his New Economic Policy (NEP) in August 1971, prices had been rising at a 5 percent average annual rate over the preceding two years, unemployment had more than doubled to 6 percent, and the nation's foreign trade and balance of payments had deteriorated sharply. To cope with the problem of inflation, the program imposed an initial freeze in prices and wages followed by successive phases of more flexible controls designed to reduce inflation to no more than a 2.3 percent annual rate by the end of 1972. Interest and dividend payments also were subject to limits and guidelines.

At the same time, the program embraced broadly stimulative fiscal and monetary policies, including various measures designed to promote productivity and employment, such as an investment tax credit. To correct the deteriorating balance of payments, the NEP called for a temporary 10 percent import tax, successive devaluations of the dollar amounting to about 20 percent, the end of convertibility of foreign official holdings of dollars into gold, and abandonment of the system of fixed exchange rates that had prevailed since 1946 in favor of one of flexible rates.

The immediate results appeared favorable as real growth (and exports) picked up, and unemployment, interest rates and the rate of inflation all receded. Controls consequently were relaxed in the direction of voluntary compliance under the scrutiny of the Cost of Living Council.

However, prices subsequently rose sharply, partly in response to worldwide crop failures and large sales of U.S. grain to the Soviet Union. In the summer of 1973, a price freeze was again imposed, except on unprocessed farm products, while wages, interest, and dividends remained subject to guidelines. Sharp OPEC oil price hikes in late 1973 and subsequent embargoes early in 1974 exacerbated cost pressures.

But the public had become disenchanted with the NEP. The President's Council of Economic Advisers concluded that the track record of the controls was "poor," and the NEP came to an end with the lapse of Congressional authority in the Spring of 1974.

A fistful of dollars

In spite of periods of transitory abatement, the problems that afflicted the nation's economy — inflation and high unemployment (spawning the term "stagflation") — continued to confront policymakers throughout the decade. Between 1974 and 1978, prices rose at over a 7 percent annual rate and unemployment averaged over 7 percent.

In 1978, President Carter called for an all-out war on inflation and late that year imposed wage and price guidelines of 7 and 6½ percent, respectively, along with a package of measures again designed to prop up a sagging dollar. However, subsequent wage increases were accompanied by net *declines* in productivity, with the result that unit labor costs and prices in 1979 continued to soar.

In its 1979 *Annual Report,* the Federal Reserve Bank of San Francisco noted that "the decade of the 1970s experienced some notable achievements — and some notable failures." On the "plus" side, real GNP increased by 36 percent and aggregate real personal income by 26 percent in response to the creation of 21 million jobs. But on the "minus" side, unemployment, although down from 7-8 percent in 1975-76, remained high at 6 percent at the end of the decade, and the price level almost doubled, leaving some groups (including the average production and nonsupervisory workers) with a net loss of purchasing power.

Nominal market interest rates reached double-digit levels by the end of the decade, while rate ceilings imposed on the deposits of banks and thrift institutions — a selective form of price control — periodically resulted in substantial savings outflows in favor of higher yielding market instruments.

Atlas winced

A host of factors interacted to make the 1970s the worst decade of inflation in the nation's history. They included a 15-fold increase in OPEC oil prices, a tripling of raw material prices in response to economic booms in most of the industrial countries, and widespread crop failures that contributed to a doubling of food prices.

Domestic government spending also contributed heavily. America's involvement in the Viet Nam war wound down in 1972, but total federal outlays, primarily to expand entitlement programs, nearly tripled over the decade. The increase far outpaced revenues, which were constrained by tax reductions in 1971, 1975, and 1977. The results were deficits aggregating $365 billion — exceeding the net total of all deficits incurred in the nation's previous 193-year history.

In 1974, CEA Chairman Alan Greenspan noted that inflation ultimately reflected pressure on the Federal Reserve to accommodate much larger increases in the money supply than it normally would sanction. Pressure came from heavy government demands in the credit markets, which were pre-empting a steadily increasing portion of savings. Inflation, in turn, contributed to enormous private demands for credit. Both consumer and mortgage debt about tripled over the entire decade, partly in response to expectations of continuing inflation, which, along with interest tax deductibility, sharply reduced "real" borrowing costs.

For his part, Arthur Burns, Fed Chairman from early 1970 to early 1978, repeatedly urged upon the Congress the need for greater fiscal restraint ("deficits in the Federal budget must be scrupulously watched and gradually reduced"). In 1977, he added that the speed with which the Fed could decelerate the growth of money and credit without severely disrupting economic activity "is limited by the degree to which inflation has become embedded."

Policy debate

At the heart of the debate over the appropriate role of monetary policy were the differing views and prescriptions of Keynesians and Monetarists, although neither of their "textbooks" could adequately explain the phenomenon of stagflation. As reflected in the views of the staff of the Congressional Joint Economic Committee in 1977, for example, Keynesians concluded that monetary policy had been extremely tight over the preceding five years inasmuch as the *real* money supply (the nominal money supply adjusted for inflation) had shown a net decline. Many in the Congress argued that increasing production by reducing high unemployment and excess capacity were the keys to reducing inflation. They consequently favored a stimulative fiscal policy and a monetary policy that focused on keeping interest rates low rather than on limiting increases in the money supply.

Monetarists argued that strict control over the money supply was the key to controlling inflation, and that the lack of "real" growth was itself the end-product of the rapid growth of nominal money and the resulting inflation.

Various market and technological innovations also were altering the historical relationship between M1, interest rates, and income. In the meantime, the Fed was being roundly criticized by both sides in the policy debate — by Keynesians for being too restrictive, and by monetarists for being too expansive.

Congress generally accepted the Keynesian view although early in 1975 it also gave tacit recognition to the importance of the monetary "aggregates" when it adopted Concurrent Resolution 133. The economy was in a recession that had started in 1974, and Resolution 133 expressed Congress' "resolve" that the Federal Open Market Committee (which makes monetary policy) pursue policies in the first half of the year to encourage lower long-term interest rates and expansion of the monetary and credit aggregates "appropriate to facilitating prompt economic recovery."

In fact, interest rates already had started to drop and the money supply to expand. Two years of substantial real growth and falling unemployment and interest rates would follow — together with accelerating inflation and, inevitably, record high interest rates.

Structural reforms, increased responsibilities

The decade of the 1970s also witnessed substantial changes in the structure of the Fed and the

MONETARY POLICY OBJECTIVES FOR 1986 AND 1987

On July 23, Federal Reserve Board Chairman Paul Volcker presented a mid-year report to the Congress on the Federal Reserve's monetary policy objectives for the remainder of 1986 and its proposals for 1987. The report reviews economic and financial developments in 1986 and presents the economic outlook heading into 1987. For single or multiple copies of the report, write to the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco, CA 94120, or phone (415) 974-2246.

scope of its responsibilities. In 1976, the House Banking Committee made a number of recommendations to help the System deal more effectively with the increasingly complex problems that characterized the economy, and also to make it more "accountable" to the Congress and the public.

Subsequently, the Congress vastly expanded the Fed's responsibilities in the field of supervision and regulation, including its authority over bank holding companies and its rule-writing and enforcement authority under a dozen major consumer protection laws enacted during the decade (such as the Equal Credit Opportunity and the Community Reinvestment Acts).

The Federal Reserve Reform Act of 1977 substantially broadened the criteria for selecting Reserve Bank directors to give due consideration to the interests of services, labor and consumers, as well as agriculture, industry and commerce, without discrimination as to race, creed, color, sex or national origin.

In addition, the Act called on the Board to report semi-annually to the House and Senate Banking Committees on its goals and "targets" for the monetary and credit aggregates (e.g., M1 and M2) over the ensuing twelve months, and to maintain long-term growth of the aggregates "to foster increased production, maximum employment, stable prices and moderate long-term interest rates." During mark-up of the bill, the House Banking Committee responded to Chairman Burns' objections that it would trigger speculation by narrowly rejecting a provision that would have required the Fed to provide forecasts of interest rates.

Congress passed the Humphrey-Hawkins "Balanced Growth and Full Employment Act" in 1978. The Act required the Board specifically to discuss its plans and "targets" for the monetary and credit aggregates in relation to the short-term (two-year) economic goals (of GNP, employment, prices, etc.) specified by the President in his annual *Economic Report*. After fierce debate, the Act also stipulated adult unemployment and inflation goals of 3 percent by 1983 (and zero inflation by 1985) *provided* that policies and programs for reducing inflation do not impede the goals and timetable for reducing unemployment.

Crossing the Rubicon?

During the 1970s, the Fed continued to attempt to influence the growth of deposits and the money supply *indirectly* by influencing the Fed funds rate (the rate at which banks borrow from one another) and the cost of the reserves that support deposit growth, rather than *directly* by influencing the quantity of reserves by buying and selling government obligations in the market. This procedure was flawed by a bias to react too late in a climate of rising prices and interest rates. Under the impact of soaring budget deficits and an enormous demand for credit from the private sector, it had *pro*-cyclical effects, that is, it amplified swings in the business cycle.

On balance, M1 about doubled, and M2 far more than doubled during the decade. Consequently, on October 6, 1979 — two months after Paul Volcker was appointed Chairman by President Carter — the System announced a series of steps to "assume better control over the expansion of money and bank credit." The steps included an increase in the discount rate (to a record 12 percent), additional reserve requirements on various "managed liabilities," and, most important, procedures for controlling reserves directly rather than indirectly through the Fed funds rate.

These steps ushered in the transition to the Brave New World of the 1980s, which will be the subject of a future *Letter*.

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Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

Editorial comments may be addressed to the editor (Gregory Tong) or to the author . . . . Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 8/6/86	Change from 7/30/86	Change from 8/7/85 Dollar	Percent[7]
Loans, Leases and Investments[1 2]	200,067	380	5,294	2.7
Loans and Leases[1 6]	182,039	156	5,824	3.3
Commercial and Industrial	50,801	− 6	− 718	− 1.3
Real estate	67,146	182	3,095	4.8
Loans to Individuals	39,351	− 157	2,737	7.4
Leases	5,516	6	120	2.2
U.S. Treasury and Agency Securities[2]	10,436	71	− 1,182	−10.1
Other Securities[2]	7,592	153	651	9.3
Total Deposits	206,549	2,496	7,751	3.8
Demand Deposits	52,697	1,626	5,330	11.2
Demand Deposits Adjusted[3]	36,414	1,368	− 6,711	−15.5
Other Transaction Balances[4]	17,173	879	2,881	20.1
Total Non-Transaction Balances[6]	136,679	− 8	− 459	− 0.3
Money Market Deposit Accounts—Total	46,752	− 182	1,760	3.9
Time Deposits in Amounts of $100,000 or more	35,206	− 31	− 2,627	− 6.9
Other Liabilities for Borrowed Money[5]	21,625	−1,309	− 433	− 1.9

Two Week Averages of Daily Figures	Period ended 7/28/86	Period ended 7/14/86
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	79	6
Borrowings	35	23
Net free reserves (+)/Net borrowed(−)	43	− 17

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change